

# Make or break

The 7 key questions that will determine the  
success of GFANZ



THEIA  
FINANCE LABS

# **DISCLAIMER (PLEASE ACTUALLY READ THIS PRIOR TO READING THE REPORT, THIS DISCLAIMER IS IMPORTANT!)**

This note forms part of a new briefing series from Theia Finance Labs research programme called “MAKE OR BREAK” exploring the perspectives for key initiatives in the sustainable finance space, starting with a review of GFANZ. Further briefing notes are planned in the course of 2023.

The series are “opinion pieces” authored by Theia Finance Lab staff members providing a perspective on the way forward for these initiatives and key challenges and recommendations. They are not technical research reports, even where they cite research, and do not go through the same editorial review as other Theia Finance Lab research products. The ideas and recommendations presented here are attempts at discussion inputs. Goal of these notes is to surface key issues, discuss their ramifications, and outline potential resolutions. They are designed as an input to the debate. We expect part of this debate will involve changing people’s minds just as we expect us to change our mind as well.

The documents are shared with the initiatives prior to publication and discussed. However, for the avoidance of doubt, the research presented here is not affiliated with the initiatives discussed, nor subject to their editorial control, nor in any way implicitly or explicitly endorsed by them. Nor is the research affiliated with 2° Investing Initiative France and 2DII France did not have editorial input.

## **About Theia Finance Labs**

Theia Finance Labs (formerly 2° Investing Initiative Germany) is an independent, non-profit think tank incubating research solutions for the financial sector that help solve the climate crisis. The Theia Finance Labs name is inspired by the Greek goddess of sight, the light of the blue sky, and the value of gold, Theia, and by the Greek word Aletheia, which means “disclosure” or “truth”, literally “the state of not being hidden”. The new brand thus mirrors our goal to develop evidence-based research and tools that shed light on the intersection of finance, climate change, and long-term risks. Theia operates as a 100% non-profit organization.

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# Introduction

**Climate target-setting frameworks in financial markets are at an inflection point.**

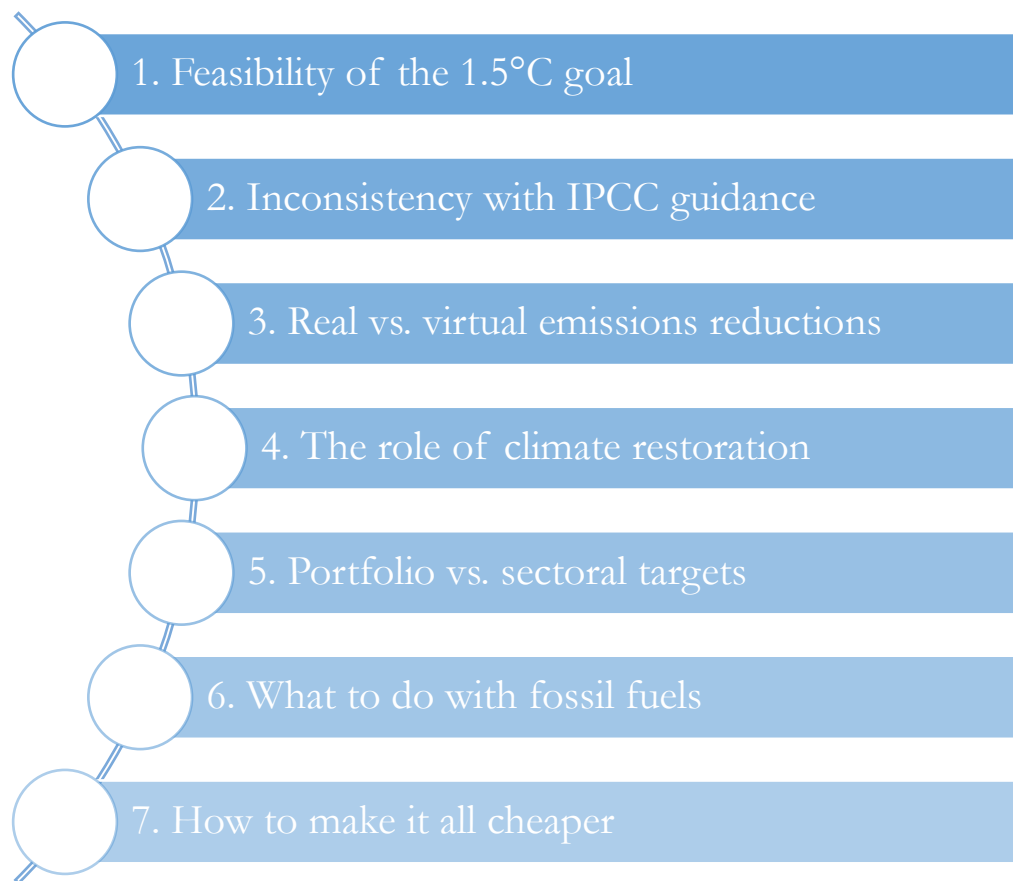
The past 5 years have seen a plethora of initiatives around portfolio targets, starting with the Portfolio Decarbonization Coalition and culminating in the Glasgow Financial Sector Alliance for Net Zero (GFANZ). It appears that these frameworks face a sort of endgame similar to the Paris Agreement in the sense that we are unlikely to see new initiatives in the course of this decade and the key focus will be on implementation. At the same time, the anti-ESG backlash in the United States represents what some consider an existential threat to these initiatives.

**The focus of this note is to identify the seven key questions or battlegrounds that are likely to shape the implementation of targets over the next years and the potential challenges and way forward across each of these.**

Incidentally, answering and resolving these issues are also likely to help address the broader strategic and governance challenges including legal risks, the role (and responsibility) of finance in contributing to real world change, and the appropriate ambition levels.

Getting these issues right is critical. This briefing note seeks to provide an input into the discussions about allowing these initiatives to be a success.

FIG 1: SEVEN KEY QUESTIONS FOR IMPLEMENTING CLIMATE TARGET-SETTING FRAMEWORKS (SOURCE: AUTHORS)



# Summary of recommendations

GFANZ needs to prepare language, communications, and target-setting protocols for a high-overshoot 1.5°C scenario to avoid being caught out potentially as early as COP28, and address the delta between IPCC and R2Z frameworks around GHG emissions.

GFANZ should formally endorse the requirement for rebaselining as part of target-setting disclosure. This requirement already exists in standards (PCAF, GHG Protocol), FSEG expert recommendations, and in GFANZ's own guidance

GFANZ should set up a dedicated working group on financing climate restoration, with a broad remit beyond nature-based solutions

GFANZ should allow for more flexibility in short-term portfolio targets to avoid portfolio optimization at expense of sector strategies and potentially driven by financial biases through use of revenues, enterprise value normalization and allocation rules

GFANZ and their members should move away from what are effectively fossil fuel divestment requirements and explore more comprehensive "impact requirements" around high-carbon emissions generation (e.g. crypto)

If GFANZ wants to reduce transaction costs, it needs to lean into a three pronged strategy of a) templates with more explicit guidance to reduce search costs, b) open-data and analytical solutions, and c) differentiated requirements for different size institutions / markets

# #1: How should GFANZ respond as the 1.5°C no overshoot window closes?

## The issue:

Most if not all target-setting frameworks currently reference a 1.5°C objective with limited to no overshoot. This is arguably more ambitious than the Paris Agreement itself.

It seems more likely than not that within the next 12-36 months, the 1.5°C goal will be fully out of reach without negative emissions technologies (and by extension, overshoot) as carbon budgets are set to tighten and emissions levels do not sufficiently drop. Policymakers are likely to reflect this reality. The key question is how target-setting frameworks will respond in both their language and criteria once 1.5°C with limited / no overshoot is not an option.

## A way forward:

It is not apparent why “temperature outcomes” are a proxy for climate ambition to begin with, given both continuous evolution of the climate science, the imprecision of temperature tracking, the uncertainty around safe warming limits (e.g. some researchers suggest temperatures need to drop again to 1°C through climate restoration), and the role of potential outside influences (e.g. volcanic activity) on temperature outcomes. Target-setting frameworks should thus maintain their focus on achieving net zero as fast as possible and focus ambition on realizing net zero in a way that minimizes the need for carbon sinks, rather than orienting ambition on temperature. This can be done through enhancing the notion of “gross zero” for certain sectors (e.g. power, road transport) and % of current emissions that may be offset by 2050 based on best available technologies and evidence.

*“This analysis reveals a wide range of possible outcomes, including no further warming, but also a 15% chance of overshooting the 1.5 °C target, and 1%–2% chance for 2 °C, even if all emissions had stopped in 2020. If emissions merely stabilize in 2020 and stop in 2040, these probabilities increase to 90% and 17%.”*

*- Sherwood et al. 2022, Environmental Research Letters Vol. 17(6)*

## #2: How should GFANZ address the gap between targets and the IPCC in terms of GHG emissions?

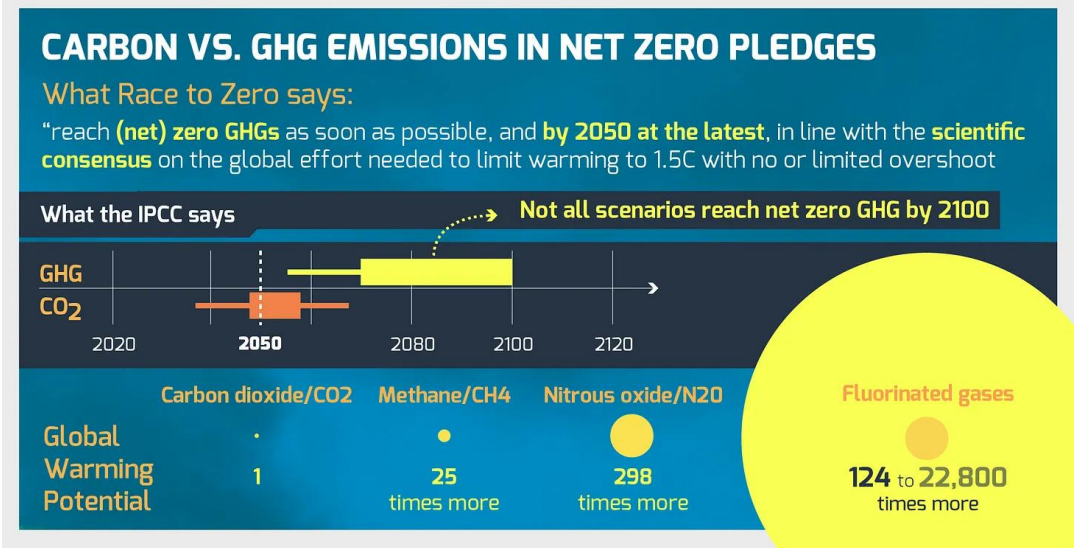
### The issue:

The Race to Zero (R2Z) framework currently requires net zero GHG emissions “as soon as possible, and by 2050 at the latest”. It claims this is based on the scientific consensus around 1.5°C. However, the IPCC actually only requires net zero GHG emissions by 2100. While some of the key emissions (e.g. methane) are set to phase out earlier than 2050 (~2060s), they are not targeted for 2050. What is more, research by Real Economy Progress highlights that not all R2Z pledges actually comply with this criteria. Over time, an ambition level exceeding the IPCC science may put additional pressure on financial institutions and complicate achievement of targets and lack of consistent application may create additional reputational challenges.

### A way forward:

The individual target-setting frameworks of GFANZ member initiatives already in part reflect this issue (e.g. NZBA). However, it seems unlikely that there is short-term political capital in favour of adjusting the overall net zero pathway and ambition level. Some stakeholders suggest in fact that this is part of the R2Z value-add, that it is even more ambitious than the IPCC. Over time however, aligning the target-setting framework with the underlying science may on its surface “reduce ambition”, but likely contribute to maintaining both feasibility of achievement and overall buy-in across stakeholders.

FIG 2: CO<sub>2</sub> vs. GHG EMISSIONS IN NET ZERO PLEDGES (SOURCE: REAL ECONOMY PROGRESS REP)



### #3: How can GFANZ take ‘real world emissions reduction’ serious?

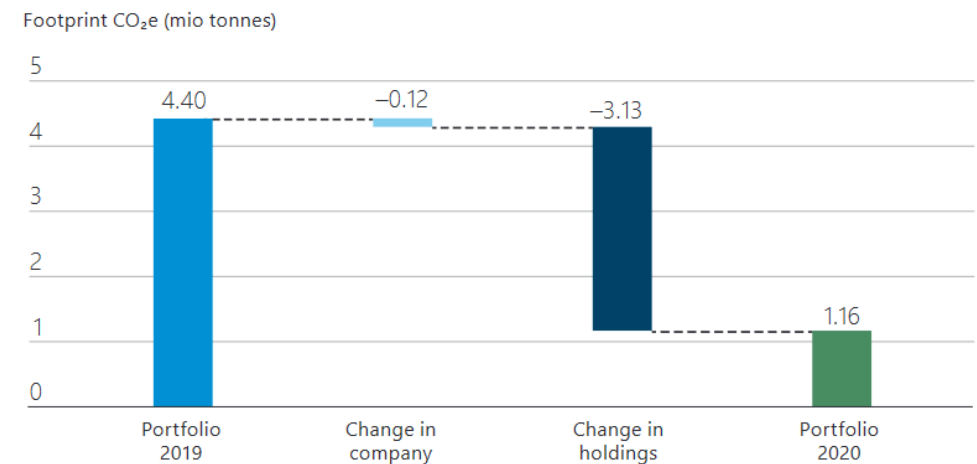
#### The issue:

All climate target-setting frameworks reference the objective of positively influencing real world emissions outcomes. The two key emissions accounting standards (GHG Protocol, PCAF) both require real world emissions tracking in some form through rebaselining, and GFANZ’s guidelines also flag this issue. Zero PCAF signatories currently comply with this standard and only a handful of financial institutions rebase (e.g. AP2). The key question for financial institutions is whether they intend to permanently ignore real emissions tracking or move towards rebaselining portfolios, and whether such rebaselining will involve only transparency in accounting or also be considered in the progress on targets.

#### A way forward:

From a technical perspective, rebaselining is relatively simple and accessible as an approach to all financial institutions, and already offered as part of packages (e.g. MSCI). While the quality of rebaselining is obviously contingent on the underlying data quality (e.g. FIs using sector averages will find little explanatory power in rebaselining exercises), there are no broader technical challenges to overcome, evidenced by the fact that some financial institutions are doing this. Ultimately, all financial institutions should comply with PCAF and GHG Protocol standard around rebaselining their disclosures. What is less clear is whether this rebaselining is simply a transparency exercise or progress on year on year emissions reductions targets should also reflect this rebaselining.

FIG 3: ATTRIBUTION OF THE CHANGES IN CARBON FOOTPRINT BETWEEN 2019 AND 2020 (SOURCE: AP2)



# #4: What is the role of climate restoration and negative emissions technologies?

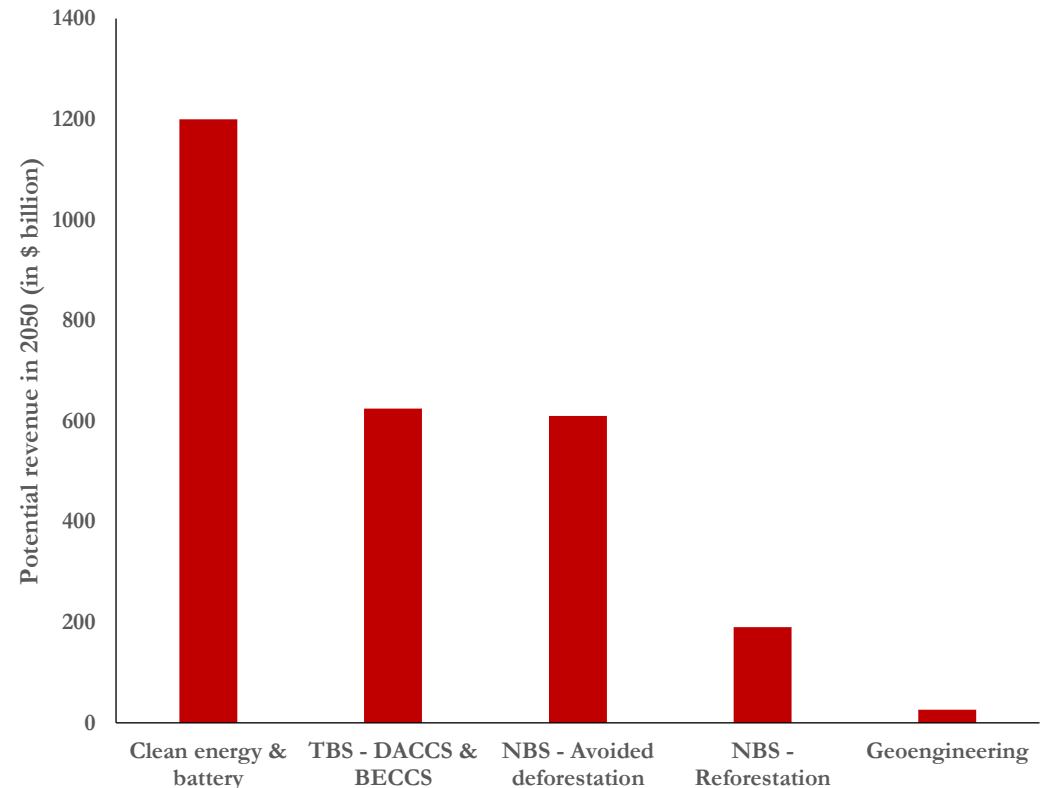
## The issue:

As outlined in Issue #1, 1.5°C with limited to no overshoot appears increasingly unlikely if not already impossible. At the same time, 2°C or more warming appears increasingly dangerous and difficult to stabilize temperatures at this level. This makes “climate restoration” (i.e. the restoration of previous temperature levels) in some form inevitable. Climate restoration will likely require at minimum negative emissions technologies – including a combination of nature- and technology based solutions and as well as potentially some form of non-traditional “geoengineering”. Financial institutions seeking to contribute to climate restoration to 1.5°C will have to identify their role in contributing to climate restoration and the ethical and social considerations that come with such actions.

## A way forward:

Climate restoration is a long-term issue and politically sensitive given the continued agenda by many NGOs against negative emissions technologies. However, once 1.5°C stabilization with limited / no overshoot is no longer feasible, the need for restoration will become more apparent. Target-setting frameworks will likely have to expand their criteria and protocols to consider their role in climate restoration actions. This will likely involve a set of voluntary social and ethical standards around financing these types of technologies and solutions, as well as discrete targets.

FIG 4: POTENTIAL REVENUES OF CLIMATE STABILIZATION AND CLIMATE RESTORATION MEASURES IN 2050 (SOURCE: THOMÄ ET AL. 2023, *forthcoming*)





## #5: How can portfolio and sectoral targets be reconciled?

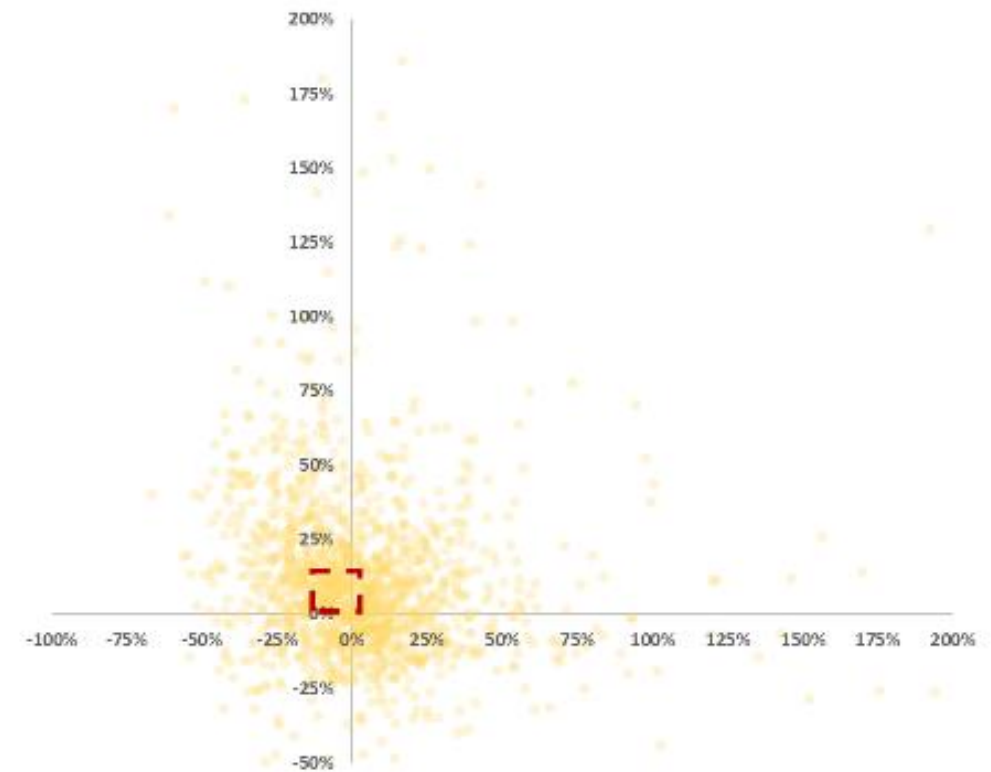
### The issue:

All climate target-setting frameworks involve some form of portfolio level targets and most in addition also involve some sectoral benchmarks. Given the challenges with portfolio footprinting (e.g. biases from financial normalization, see Fig. on right, estimation errors and data gaps), anecdotal evidence from our engagements with financial institutions suggests that steering at sector level is both more effective and more feasible. However, the high-level targets remain as portfolio footprints. Over time, it seems more likely than not, and from what we understand already in part the case, that a goal conflict may materialize.

### A way forward:

Target-setting frameworks should likely explicitly increase the flexibility to ensure that impact-oriented sector strategies are not undermined by portfolio constraints. While this needs to be well justified and structured to avoid loopholes, the alternative risk is that certain engagement actions or sectoral KPIs are abandoned or adjusted to be less optimal. GFANZ initiatives are already pointing in this direction and need to be strengthened. However, it may seem relevant to also create a hierarchy in terms of focus, as the next issue will highlight re fossil fuels.

FIG 5: VOLATILITY OF CORPORATE ENTERPRISE VALUE  
(SOURCE: THOMÄ ET AL. 2019)



## #6: What should GFANZ do about the ‘fossil fuel problem’?

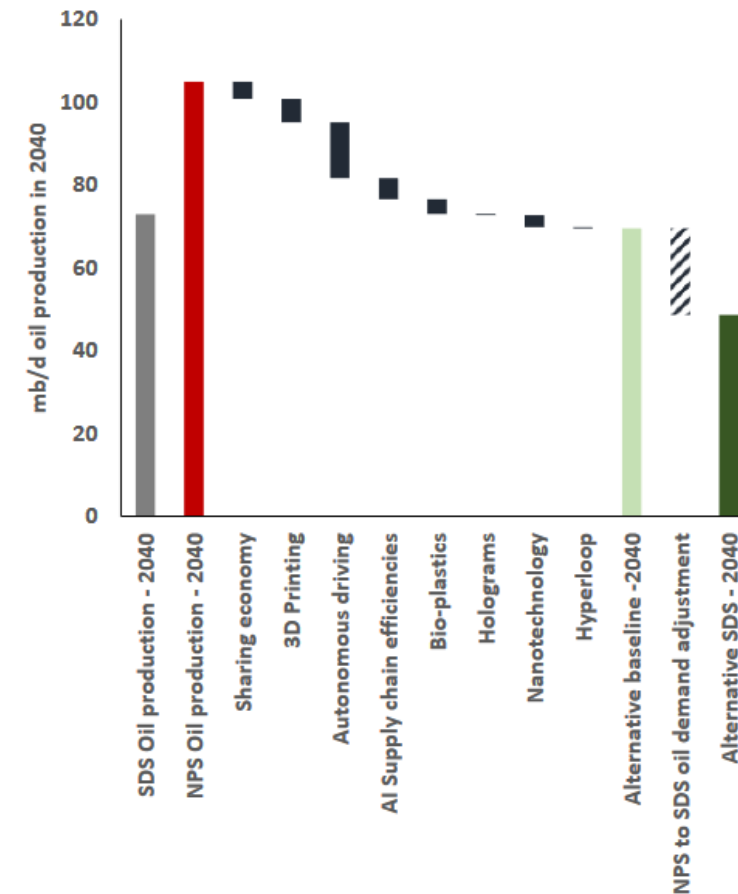
### The issue:

Fossil fuels have become the key pain point in target-setting frameworks. They are the source of contention in most legal actions given the boycotting / divestment dynamic and the anti-ESG backlash. They are also the primary source of conflict with campaign NGOs, and the most visible issue in the media. At the same time, it is entirely unclear if considering fossil fuels in target-setting frameworks is even relevant, given the collective action challenges and the role of demand rather than supply in determining fossil fuel production and emissions levels, as well as the evidence that fossil fuel divestment may increase emissions (e.g. BP Alaska). Fossil fuel demand destruction will be determined by a combination of existing and new, breakthrough technologies (see Fig. on right), rather than restricting supply, in particular given that fossil fuel assets are fixed and primarily government owned / controlled. There are also significant technical challenges around defining appropriate targets for a sector with no direct substitute.

### A way forward:

At first glance, there is no rationale for treating fossil fuels any different to the other sectors for which there is guidance but no binding requirements. It is unclear whether this would have a material effect on the overall real world impact of these frameworks. In fact, such an action may actually be positive given the reduction of legal risks and the increased focus on reducing the demand for emissions. Another approach is to think more holistically about excluded activities (e.g. proof of work crypto) that are not consistent with NZ targets and develop requirements around those. Concretely, crypto proof of work assets for example have a higher footprint than oil equities. Ultimately, it may be most effective to focus the financial sectors efforts on changing the “demand for emissions”.

FIG 6: POTENTIAL IMPACT OF DISRUPTIVE TECHNOLOGIES ON OIL DEMAND IN 2040 (SOURCE: THOMÄ ET AL. 2019)



## #7: How can this all be cheaper (reduce transaction costs)?

### The issue:

The target-setting frameworks of GFANZ and similar initiatives have become increasingly complex over the past years, in part due to NGO and public pressure to reflect the complexity of climate change and impact-oriented target-setting, in part as well however to lack of investment in streamlined systems, processes, and templates that minimize the transaction costs for less well-resourced organizations. Part of this challenge is the Catch-22 that target-setting organizations face where they do not want to provide specific guidance that risks favouring one or the other data provider or stakeholder, but by failing to do so increasing search and other transaction costs. Initiatives like a public data repository currently being proposed may be part of the solution, but they can only go so far and are likely to take time. Moreover, current GFANZ guidance is more oriented towards capacity building and high-level guidance rather than specific measures on reducing costs.

### A way forward:

2023-2024 has to have a key focus on reducing transaction costs. Especially for smaller financial institutions, there has to be an increased willingness to endorse standardized templates, open-source assessment systems, and to allow for more differentiated compliance frameworks. In particular, portfolio level tracking should in principle not be a high transaction cost exercise, given existing free solutions. On the sectoral and action levels, more targeted optionality around strategies and tracking seems appropriate, not the least if the goal remains to mobilize non-developed market actors.

Templates

Endorsement  
of free  
solutions

White label IT  
systems

Differentiated  
requirements

Targeted  
sector  
requirements



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